RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038

26 LETTERS PER YEAR • $225 ANNUALLY

Nov. 16, 1988 **LETTER 1004**

Nov. 4 DJIA 2145.80; PTI 2822; A-D Ratio -11.11
Nov. 11 DJIA 2067.03; PTI 2804; A-D Ratio -12.14
Current Dow Yield: 3.81%; Dow P/E: 12.3
Dow 200-day MA: 2065; DowPow: 665
Percentage of undervalued blue-chips: 19%

NOT EASY: This isn't a particularly easy Letter to read, but then this isn't a particularly easy market to write about. What we've got here is a mixed-up, diverging stock market, one that's had analysts pulling their hair all year (what else is new?). I've gone back into history for this Letter, citing some examples of other confusing periods that I think will help us understand what may be happening today. As I said, this Letter isn't easy reading, but it's important reading so please bear with me.

As to the schizophrenic stock market, I enjoy writing about it, although I'm not in it. But that's OK, because my subscribers and I can survive without the stock market for a while. I've been recommending municipal bonds for quite some time, and recommending them strongly since the crash.

I figure it this way: The bonds are up around 15% to 20% since October '87, and when you add a tax-free 8% (bond interest), that not half bad. Money is money, and a 25% total return in a year (part of it tax-free) is more than enough for this writer.

MARKET PICTURE: You'd never know it from reading most market advisories, but there have been long periods in stock market history when the indicators, the barometers, and the stock averages themselves weren't giving you a clear-cut picture of the trend. Here's another shocker -- this could be one of those times.

You think 1987-88 has been difficult? How about a few comparisons to mull over? Let me give you a few selected, hair-pulling examples from bear markets of the past. **1937-42:** The Dow hit a bull market high of 194.40 in March 1937. A bear market collapse followed. By March 31, 1938 the Dow had fallen to a low of 98.95. Next, a recovery set in, and by November 1938 the Dow had rallied back to 158.41. For the next four years the Dow fluctuated between the 1938 bear market low of 98.95 and the 1938 high of 158.41. In mid-1941 the market headed down, and the decline carried well into 1942.

On April 28, 1942 the Dow broke below its 1938 low by a few points -- to close at an eight-year low. This was the famous WW II low of Dow 92.92. The Dow hasn't been back there since. Some analysts believe that the 1937-42 period was composed of a series of mini bull and bear markets. I disagree. I believe that the entire 1937-42 period was one difficult, confusing, costly bear market (even though the Dow at its final 1942 low, closed only three points below its 1938 crash low).

Next case, **1946-49:** On May 29, 1946, the Dow recorded a bull market peak of 212.50. A bear market collapse followed, taking the Dow down to a low of 163.12 on October 9, 1946. By July 24 of the following year the Dow had recovered to a high of 186.85. In mid-June of 1948, after a series of confusing moves, the Dow pushed to a still higher close of 193.16. A new decline followed, a decline that carried to mid-1949. On June 13, 1949, the Dow closed at the famous low of 161.60. Surprisingly, that low was only two points under the 1946 bear market low of 163.12.

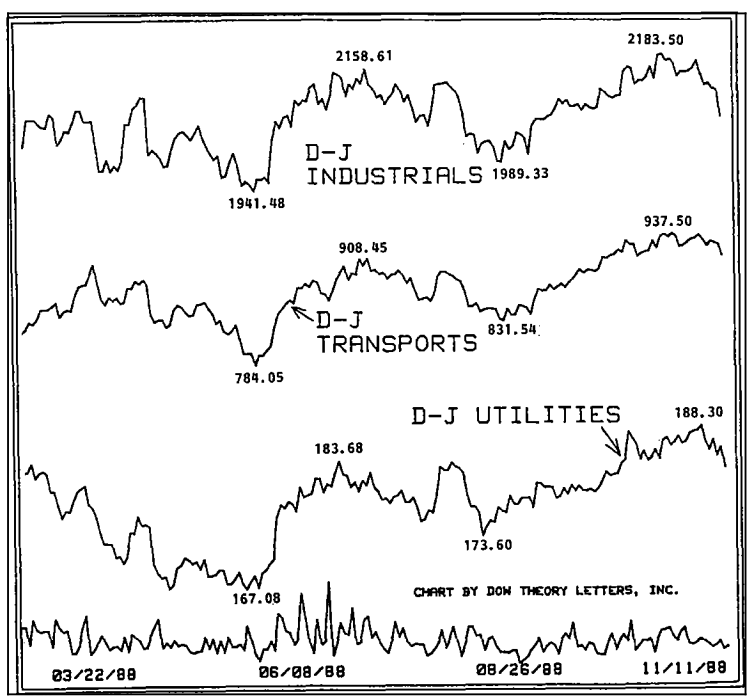
There has been much arguing about whether the confusing 1946-49 period was made up of a series of mini bull and bear markets or one long bear market. I use the Dow yield cycle to clarify the issue. The Dow's yield at the 1946 high was 3.2%, in the area of overvaluation. The Dow did not hit bargain level yields until mid-1949, at which time the Dow yield rose to 6.9%. Thus I view 1946-49 as a single major bear market -- with minuscule yields at the beginning of the bear market and irresistibly attractive yields at the bottom.

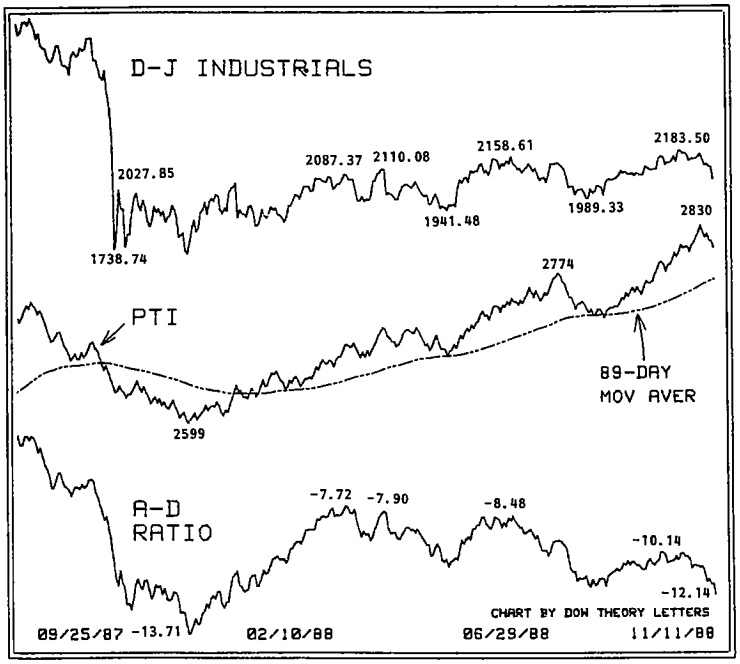
Third case, **1966-74**. That was a beaut. A great bull market topped out at Dow 995.15 on February 9, 1966. The Transports recorded their high at 271.72 on February 15. During the next eight years the Averages whipped back and forth, but at no time did both Averages better their February 1966 peaks together. Was it a confused series of mini bull and bear markets that followed the 1966 top? Or did the whole eight-year period amount to a fantastically complex and frustrating bear market?

If we judge by the yield cycle we would have to conclude that it was one huge, complex bear market. The Dow provided a minuscule yield of 2.8% at the 1966 top, and it did not provide bargain yields until late-1974, at which time the Dow yield climbed to 6.4%. At any rate, I sold all my stocks at the '66 top, and I bought my head off at the '74 bottom. As for the long span in between, I collected interest and waited patiently (sometimes impatiently), but in the end Wall Steet gave us a great, high-yield, bargain bottom.

Question: Will this bear market develop as something easy, un-complex, and identifiable? Or will we have to go through a period like 1937-42, 1946-49 or (God forbid) a period like 1966-74? I wish I had the answer to that question, but I don't.

Normally, after a crash, the market will mount a strong recovery, a recovery that takes the form of a buying stampede. Everyone jumps





in to buy the bargains created by the crash. But what do we have today? Eight months of divergence with the Dow posting recovery highs while the majority of stocks (as measured by the A-D ratio) are sinking.

What does that action tell us? It suggests to me that this is going to be (as I've been predicting all along) a very difficult, confusing bear market, a yawner in some segments, a hair-puller in others. The fact is that this market's already been a devil to read and figure out -- and we're only a year into the bear.

But I've been through these babies before, and I have patience, lots of it. Along these lines I've included in this Letter a section entitled "Rich Man, Poor Man." This section is all about patience, attitude, and strategy. Please, read it carefully. It could change your thinking about what you're doing with your money and why.

One of the mysteries in this market is the strength of the PTI as compared with the weakness in DowPow. But I'll make this observation: In the past when the PTI was posting a series of new highs (as it has been doing) while the Dow was "resting," it has not been a good sign. In such cases the market was using up its technical strength (as revealed by the PTI), while the Dow and the rest of the market were failing to respond. Ultimately, the PTI turned down with the market. But remember, we won't see real trouble in this market until the Dow and the PTI go down together -- not for just a day or two, but on a trend basis. (Note: The PTI reached its high on November 3 at 2830 -- see page 2 chart).

Question: Russell, in the 1937-42 and 1946-49 bear markets, the Dow hit a crash low early in the bear market. Years passed, and at the final low (in 1942 and again in 1949) the Dow violated its earlier crash lows by only a few points. Are you implying that this bear market could ultimately end (maybe a few years from now) with the Dow breaking the October 1987 crash low of 1738.74 by maybe only 5 or 10 points?

Answer: Anything is possible where the market is concerned. However, you will note that I stress VALUE as one of the best criteria of both bull market tops and bear market bottoms. Almost all the bear markets in modern history have ended when the average yield on the Dow pushed above the 6% level.

If, with current dividends, the Dow was to drop to a level where it was yielding 6%, the Dow would have to decline to 1276. However, if this is to be a full-fledged bear market of major proportions (and I suspect it will be) then dividends will be cut as the bear market moves into its second and then its third phase. In that case, the Dow would have to drop below 1276 in order to provide a 6% yield.

Question: Is there anything in the current picture that indicates that this could or will be a bear market of historic proportions?

Answer: There are a number of items that worry me. (1) The first phase of this bear market has lasted a long time, over a year, and it is still going on. The first phase, if you remember, is the phase where stock prices go down in the face of continuing good business. Usually, the first phase is a short phase, but the 1987-88 span is the longest first phase on record.

Normally, the second phase of a bear market is the longest phase. The second phase is the one in which stocks go down as they reflect obviously deteriorating business conditions. We haven't arrived at phase two yet, but since phase one has lasted over a year, I would expect phase two to last quite a bit longer -- may two or three times as long. That's hardly a comforting thought.

(2) Obviously, I don't like the debt picture -- either in the private or the public sector. In major bear markets, the bear will attack the weakest sectors of the economy, and many sectors of the American economy are weak and very vulnerable via excess debt. Furthermore, the takeover and LBO situation could prove to be a disaster when this bear market finally moves into its second phase.

(3) Sentiment is ominously upbeat at this stage of the bear market. Optimism is wonderful if it occurs at the right time, in the right place. But optimism early in a primary bear market means that people are not preparing for change, and I'm talking about negative change. There are no savings in the US, everybody is leveraged or living on debt. That's hardly comforting during the early stages of a bear market.

(4) It goes without saying that I don't like the way this bear market began. It began with what I term "the greatest trend reversal in stock market history," and I refer to the 1987 crash, an event that Wall Street and the media are trying their damnedest to make us forget. Often, the initial impulse of a move tells you a lot about the ultimate extent of the move. If that is the case here, we have plenty to worry about.

(5) I don't like the record duration of price/breadth divergence that has occurred here in 1988. The longer the divergence, the greater the potential for falling prices.

(6) Two day after the '87 crash the Dow was at 2027. Now, 13 months after the crash low the Dow is in the 2120 area. This means that the Dow has gained a mere 4.6% in the 13 months following the crash. That represents a very tired post-crash recovery. It's also unsettling that in the 13 months since the crash the Dow has failed to regain even half of the 984 points lost during August-October 1987. Both of the above observations imply technical weakness.

(7) As for the nearer term, I've often discussed the ratio of stock yields to bond (or bill) yields. At present, the yield on the S&P 500 is 3.6% while the yield on the 91-day T-bill is 7.7%. That's a ratio of better than two-to-one in favor of T-bills. When this adverse ratio has appeared in the past, it has served as a sell signal for stocks. *Growth Fund Guide* (Box 6600, Rapid City, SD 57709) has traced this stock yield/T-bill yield sell signal back 20 years. Here are the results:

Sell Signals	Maximum decline in S&P500
Dec. 10,1968	-35.4%
Dec. 6, 1972	-47.2%
October 17 1979	- 5.0%
August 27, 1980	-17.1%
May 25, 1983	-11.1%
July 1 1987	-26.1%
October 12, 1988	?

The average drop in the S&P 500 after a T-bill/stock yield sell signal was -23.7%.

Conclusion: The market acts as if it is sensing and discounting major trouble ahead. The business boom of 1987-88, the intense speculation in LBOs and takeovers, none of this has produced anything like an impressive performance in either the Dow or the majority of stocks (the latter as measured by the advance-decline ratio).

INVESTMENT POSITION: I have about 6,500 subscribers today, and I believe my subscribers have one thing in common. What they have in common is that they tend to be intelligent and fairly sophisticated. My subscribers come from all 50 states, and 37 foreign nations. Some subscribers are pension fund managers, some are bankers and brokers, many are corporate officers and obviously a great many are simply individual investors. I'm not at liberty to name names, but I can tell you that many of the men and women on the *Forbes* list of "Richest Americans" are subscribers (and obviously they're welcome), but as far as I'm concerned their $225 subscription is no more treasured than a subscription from a store owner in Buffalo or a banker in Lucerne.

The real point I want to get across is that the needs of my subscribers are vastly different. So are their psyches and so are their responsibilities. I don't have to tell you that the needs of a pension fund manager who manages $4 billion in funds (with $millions coming in each week) are vastly different from that of a widow who lives on the income from a $250,000 trust.

By the same token, the way I invest is suited to my own needs and psyche. I tend to think as a conservative, value-oriented, risk-averse investor, yet I'm well aware that a great many of my subscribers are traders and big risk-takers. For them I offer my Primary Trend Index. Stay on the right side of the PTI in your trading and I believe that you'll find the PTI alone worth the price of an annual subscription to this service.

For the majority of my investor-subscribers I offer Dow Theory and my own philosophy, developed through 40 years of watching and struggling with the markets. I never ask subscribers to do what I wouldn't do myself. But I can certainly understand subscribers who want to be more adventurous than I am in investing. If I had a personal investment motto it might be this -- "First rule, don't lose money." The corollary to that is, "If you don't lose money, you'll probably make it."

In running this business and investing for myself for many years I've done well financially. Therefore, I don't need to trade or speculate. In other words, I'm not pressured to do anything. And I do tend to write from that perspective (and I like that perspective). But as I said, if you want to be more adventurous, I certainly don't blame you.

Right now I'm doing nothing in the markets. I've been out of stocks since before the crash, and I've recently stopped buying bonds because I can't get the kind of yields I was geting three years ago or a year ago or even six months ago. So I'm putting all new money into municipal cash fund accounts (i.e., tax-free money market funds) while remaining on my program of buying a conservative number of gold coins each month. That's my investment position. If it changes, I'll let you know -- pronto.

STOCKS, BONDS: With the yield on the Dow around 3.6%, the question arises, "What are stocks worth compared with bonds?" Steve Leuthold (who does outstanding institutional research) offers a number of critical thoughts on the subject.

Leuthold notes that at the bull market peak in August 1987 we witnessed the highest ratio of bond yields to stock yields for any quarter since 1926. The ratio was 3.75, whereas the average ratio for all the years since 1926 has been 1.38. Even at today's ratio of 2.6, the average has been lower 90% of the time since 1926.

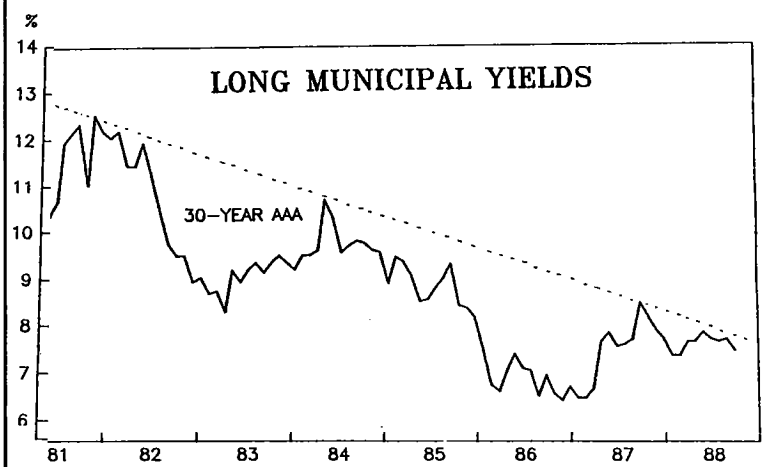
Leuthold compares the earnings yield on stocks (i.e., earnings divided by price) with the yield on bonds. Currently, the earnings yield for stocks is 7.7% while the yield on Barron's Best-Grade bonds is 9.45%. This differential (in favor of bonds) is greater than it has been 90% of the time since 1926.

Leuthold believes that there is a chance that the next administration will move to solve its deficit problem. If that happens, bond yields could drop to near their average rate since 1790 which would be 5.17%. If, over the next four years, bond yields drop to 5.5% (their average rate over the past 60 years) the total return to investors would be 100%, an 18.8% compound annual return.

How about stocks? If stocks produce average earnings and dividends over the next four years and P/E ratio are at their long-term average of 15, investors would receive a total return of only 28% from stocks for an annual compound interest rate of 6.4% -- including dividends. In that case, bonds would be the overwhelming winners. What would stocks have to do to match Leuthold's bond calculations? The Dow would have to rise to 3835 over the next four years.

Thus Leuthold is saying that just as the ratios told investors to switch from stocks to bonds last summer, the cold figures are telling investors to move out of stocks and into bonds. Russell opinion: I also believe that bonds at this point represent a better value than stocks. My only reservation is that the bonds have climbed awfully far awfully fast over the last year -- and that too many late-comers are now shouting "buy bonds." Thus, although I like bonds, a correction could be in order.

By the way, I've been saying that after 35 years in a primary bear market, the bond market turned bullish in the early 1980s. This chart shows what's happened to bond yields during the period of 1981 to the present. It also shows why buyers of bonds have been smiling.



Subscribers should note that I have advised buying only municpal bonds with rating of AA or better, and I have avoided insured bonds. If a bond needs insurance, if it can't stand on its own, I don't want it (besides, who insures the insurers -- remember the S&Ls?).

As far as buying quality is concerned, ponder this. In 1987 123 muni issues worth $1.1 billion defaulted, which represents more defaults in a single year than the defaults of 1972 to 1983. So far in '88, 60 muni issues have defaulted. Most of the defaults were in tiny, little- known issues, but gullible investors bought a lot of these. The bonds most at risk today are the so-called "conduit bonds" guaranteed by private corporations, not government

entities. Stay safe -- buy only investment-grade AA-rated or better munis.

RICH MAN, POOR MAN: Last week a subscriber called to tell me that a piece I penned back in Letter 844 (Sept. 22, 1982) was so important to him that he's been sending a copy of it to his children every year since. I re-read the piece, and I do think it's a very important concept. It's so important, in fact, that I rewrote the section and am including it below.

In the investment world, wealthy investors have one major advantage over the little guy, the stock market amateur and the neophyte speculator. The advantage that the wealthy investor possesses is that he DOESN'T NEED THE MARKETS. I can't begin to tell you what a huge difference that makes, both in one's mental attitude and in the actual handling of one's account.

The wealthy investor doesn't need the market because he already has all the income he needs. He has money coming in via bonds, T-bills, money market funds, real estate, and stocks. In other words, the wealthy investor never feels pressured to "make money" in the market.

The wealthy investor tends to be an expert on **values.** When bonds are cheap and bond yields are irresistibly high, he buys bonds. When stocks are on the bargain table and stock yields are attractive, he buys stocks. When real estate is a great value, he buys real estate. When great art or fine jewelry is on the "giveaway table," he buys them. In other words, the wealthy investor puts his money where the values are. And if there are no outstanding values, the wealthy investor waits. He can afford to wait. He has money coming in daily, weekly, monthly. In other words, he doesn't NEED the market. He knows what he's looking for, and he doesn't mind waiting weeks, months or years (they call that patience).

What about the little guy? This fellow always feels pressured to "make money," to "force the market to do something for him." When this fellow isn't buying stocks at 3% yields, he's off to Vegas or Atlantic City trying to win at craps or he's spending ten bucks a week on lottery tickets or he's "investing" in some crackpot real estate scheme with an outfit that his bowling buddy told him about. And because the little guy is forcing the market to "do something for him," he's a consistent and chronic loser. The little guy doesn't understand values so he always overpays. He loves to gamble, so he always has the odds against him. He doesn't understand compounding, and he doesn't understand money. He's the typical American and he's perpetually in debt.

The little guy is in hock and he's always sweating, sweating to make payments on his house, his refrigerator, his car or his lawn mower. He's impatient, and he constantly feels pressured. He tells himself he has to make money fast. And he dreams of "big bucks." In the end the little guy wastes his money in the market, he loses his money on gambling, he dribbles it away on senseless schemes. In brief, this "money-nerd" spends his life running up the down-escalator.

Now here's the ironic part of it. If, from the beginning, the little guy had adopted a strict policy of never spending more than his income, if he had taken that extra income and compounded it in safe, income-producing securities -- in due time he'd have money coming in daily, weekly, and monthly just like the rich guy. And in due time he'd start acting and thinking like the rich guy. In short, the little guy would become a financial winner instead of a loser.

Here are a few Russell definitions: Being happy financially is having no debt, owing nobody anything, having money coming in and being able to reinvest that money, all the while living on your earnings alone.

Technically rich: Being in a situation where you can lose your job or your business but still have enough outside income so that the loss of your job or business makes no difference in your standard of living.

Just plain rich: Having $5 million in income-producing assets (no debt) and living in rural America. Or having $10 million or more in income-producing assets (no debt) while living in a major city or in a wealthy suburb.

NOTES & QUOTES: Unlike Reagan, Bush won the election with no Republicans riding on his coat tails (actually, the Republicans lost on balance in Congress). With a Democratic Congress in control, this does not bode well for much getting done in the Bush era. Furthermore, Bush did not win with a big majority of the popular vote, so Congress won't feel any pressure to cooperate with the new president. "A political honeymoon?" snaps one Democratic Congressman, "there won't even be a first date."

I believe Bush is going to be pressured immediately about his plans for reducing the federal budget deficit. That's where the trouble will begin. It would be almost unthinkable for Bush to go back on his "read my lips, no taxes" motto during his first year in office. But the markets aren't interested in presidential slogans, and a sudden swoon in the dollar could force Bush and Congress to the wall.

* *

"It's a New World" Dept: The Japanese are proceding with plans to make their powerful yen an international currency, displacing the dollar in some areas including Asia. Aside from the prestige factor, using the yen would reduce foreign exchange risks for Japanese exporters and lenders.

* *

New York may be "Fun City" but it is also snob city. *New York Woman* (an excellent new magazine) discusses what it takes to get into "the toughest ten," the City's notoriously picky top cooperatives. To get in one of these buildings (i.e., 834 Fifth, 775 Park Ave., 960 Fifth, 1020 Fifth, The River House, etc.) you will have to pass the co-op board, many of which require the following: (1) you must pay completely in cash; (2) you must be very liquid (often they will want a net worth of $10 million); (3) it's an unspoken rule that you can't be an entertainer or (usually) Jewish; (4) you must be active in the "right" charities (NY Public Library) and belong to the right clubs (Metropolitan, Knickerbocker), and (5) you need good references, and they don't mean Donald Trump, they mean Brooke Astor, David Rockefeller, a Whitney or someone in the Social Register. . . . After Nixon's disgrace, all the co-ops he applied to turned him down. Gloria Vanderbilt was turned down at River House because she palled around with Bobby Short.

* *

The big banks have loaded up again with questionable loans. What is it this time? It's loans for leveraged buyouts. Here are some figures: Citicorp with $4 billion in LBO loans now shows these loans as 43% of its total equity. Bankers Trust has LBO loans of $3.5 billion or 104% of total equity. Wells Fargo has loans of $3.5 billion or 138% of equity. Mfg. Hanover has loans of $3 billion or 98% of equity. JP Morgan has loans of $3 billion or 53% of equity. Chase Manhattan has loans of $2.5 billion or 54% of equity. Chemical Bank has loans of $2 billion or 60% of equity. To all these banks -- good luck.

* *

Statistics: In 1984 borrowing for buyouts amounted to $16.2 billion, in 1987 it was $39 billion, in 1988 so far it is $90.9 billion.

* *

Speaking of debt, its quality isn't getting any better. In the first half of 1988 S&P lowered the investment ratings on $216 billion worth of US corporate securities while raising the rating on only $130 billion. Said Dr. Henry Kaufman, "If this deterioration of corporate debt is occurring in the course of an expansion, you can imagine what will happen to a lot of corporate debt in a recession."

* *

I've been doing a lot of thinking about the whole LBO/takeover phenomenon. In all honesty, I can't really blame Kravis or Trump or Icahn for going after the big multi-millions. After all, what they're doing is legal, isn't it? What makes it all possible? It's our system of writing off the cost of interest on debt. Of course, that's

legal too (in fact, the government encourages it). In the end, the next recession will bankrupt some, maybe most, of the debt–ridden LBOs and takeovers. At which point what's left of these companies will be refinanced, pieced together, sold off in part or what have you. Finally, they'll change the laws on writing off interest on debt or put a ceiling on debt -- and probably dream up some new laws which will further speculation a new and different way.

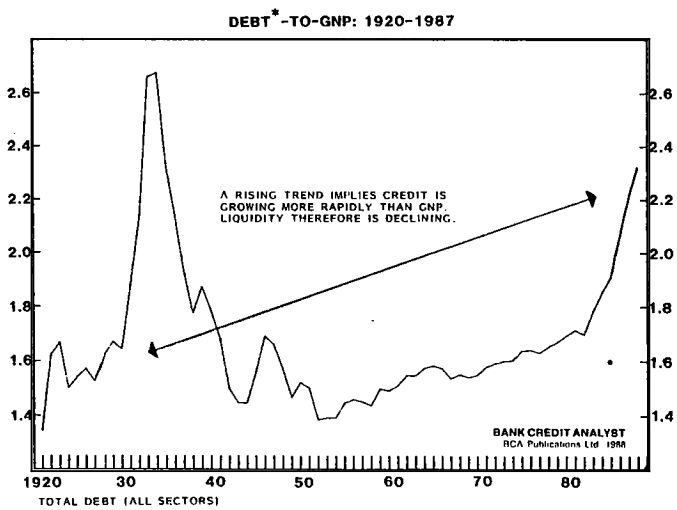
To me, the sad part of the whole thing is that in taking on all this debt, the companies must cut costs and services (and not all the cost-cutting works out for the good of the corporation). In the process, thousands of workers are laid off. Furthermore, the huge debts taken on by the companies makes them vulnerable to bankruptcy when times get rough. The additional debt in almost all cases adds nothing to the corporation's ability to function. But to me the worst aspect of the LBO/takeover game is that it makes American corporations less able to compete in world markets. To that extent, it renders the US a weaker competitor in the world economy, hardly what we need if we are to survive as a world power.

When Campeau came out a few weeks ago with a junk bond issue, Wall Street turned it down. Then Campeau came out with a sweetened issue, part of which (half a billion dollars worth) consisted of bonds paying 16% and due in 12 years. Who would buy them? The issue sold out, so figure it this way: At 16% you get half your money back in three years. If Campeau goes belly up, the bonds should be worth at least 50 cents on the dollar. My feeling: Probably not a bad deal, but I like to sleep nights, and who needs it.

In the meantime, Macy's (an LBO) is causing many of its junk bond holders to perspire a bit. Macy's has announced of $106 million loss for the quarter and a full year loss of $188 million. Macy's is suffering from severe retail competition and higher costs due to its efforts to provide "higher levels of customer service." Macy's is also suffering from a tremendous debt load of $4.4 billon.

* *

Debt: This chart illustrates the rise in debt in the USA as a ratio of the GNP. Since the early '80s, the ratio has been exploding. Note the the earlier peak recorded during the Great Depression. But this peak was caused largely by a huge collapse in GNP, not a rise in debt. (Chart courtesy *The Bank Credit Analyst*, 3463 Peel St., Montreal, Quebec, Canada H3A 1W7.)



* *

Harvard Business Review has listed major cities in order of their "affordability ratio" (i.e., a city 's average housing cost divided by average wages in that city). The more affordable a city, the lower the ratio. The most affordable cities with their ratios are Detroit 2.6; Toledo, Ohio 2.7; Louisville, KY 2.7; Houston 2.8; Des Moines 2.8; Buffalo 2.9; Indianapolis 3.0. Least affordable are Wash., DC 4.7; W. Palm Beach 5.1; LA 5.8; San Diego 6.3; San Fran. 6.6; Providence 6.6; NYC 6.7; Hartford 6.8; Anaheim, CA 7.5; and the worst is Harvard's own city of Boston at 7.7.

* *

Numbers: Mike Milken of Drexel Burnham gave away an amazing $197 million in 1987. How much did he make? Tax laws limit charitable deductions to 30% of adjusted gross income. On that basis it is generally conceded that Milken made around $650 million in 1987. . . . Wyoming, deep in recession, continues as our least populated state. From a high of 505,000 in 1985, during the oil boom, its population has now sunk to 477,000. . . . M-2 (checking deposits plus cash and most kinds of savings) has, on a 2-year growth rate basis, dropped to its lowest level since the early-1960s. . . . Last year 220,000 homes in once oil-rich Denver were repossessed. . . . According to the Victims Service Agency, battering (husbands beating their lovers or wives) is the single major cause of injuries to women, exceeding rapes, muggings, and even auto accidents .

* *

When Doris Duke, the world's richest woman (wealth estimated at $800 million) put up bail for her pal, Imelda Marcos, did you notice what she put up? It was $5 million in municipal bonds. Gives you an idea of where the rich have their money.

* *

Scam: The Treasury invests the current surplus Social Security funds in so-called "Special Issue" non-marketable securities. These Treasury IOUs throw off interest, but unlike regular T-bonds they have no maturity date. Thus, the SS system has become a slush fund for the US government. The government, by counting trust-fund surpluses (a balance sheet entry) as part of its revenue, could meet the Gramm-Rudman deficit target in '87 (but the real deficit in 1987 was $225 billion rather than the reported $150 billion).

The truth is that the whole SS/deficit thing is a fraud. The irony is that the poor and the middle class (through fat and increasing SS payroll taxes) are doing the major job of covering up for the government's spendthrift ways. A recent Congressional study shows that the bottom 10% of all income groups in the nation will, in 1988, pay 20% more than they did in 1977 in the form of SS and other payroll taxes. (Thanks to *Financial World* for much of the above data).

In his latest report, Ed Hyman of CJ Lawrence writes: "The budget deficit as reported includes the Social Security surplus. The SS surplus is estimated to be $52 billion in 1989. Our estimates suggest that excluding the SS surplus, the budget deficit would deteriorate from $193 billion to $212 billion." Russell comment: Mr. Bush, here's your golden chance to give us some honesty in government.

* *

Most interesting comment of the week: From Bush's campaign chairman James Baker: "There will be a strong effort made in the next Congress, regardless of who's president, for some sort of taxpayers bailout (of the S&Ls). It would be my recommendation to Bush that it is not a smart idea." Russell comment: That's interesting, and I'm all for it. But then where the devil is the money going to come from? Or is the S&L fiasco just beginning to warm up?

* *

What are the biggest circulation newspapers in the nation? The *Wall Street Journal* is #1 with a daily circulation of 1.91 million, *USA Today* is #2 at 1.65, the (NY) *Daily News* is #3 at 1.28, the *LA Times* is #4 at 1.1, the *NY Times* is #5 at 1.03.

* *

China's economy is booming. Since 1980 real national income has increased at a 10% annual compounded rate. Fuel has come from unrestrained bank lending to all enterprises, resulting in an annual currency growth rate averaging 29% in 1984 through 1987 and 36% in the first half of 1988. This has led to an official inflation rate of 13% in the first half of 1988, but Western observers believe that the Chinese inflation could be twice that.

* *

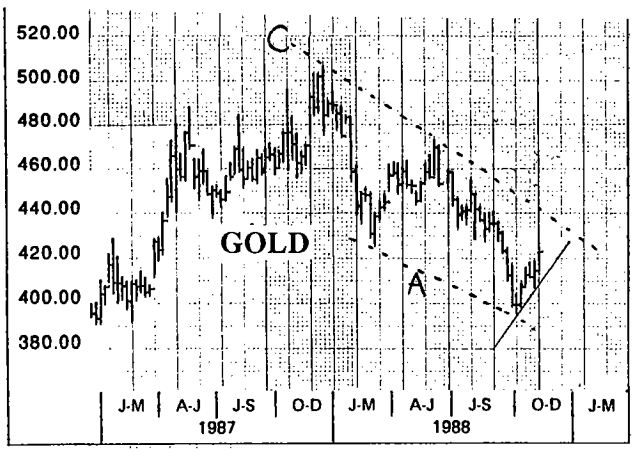
From the horses mouth: Martin Lipton of the law firm of Wachtell, Lipton, Rosen and Katz made this statement in a memo: "Our nation is blindly rushing to the precipice. As with tulip bulbs,

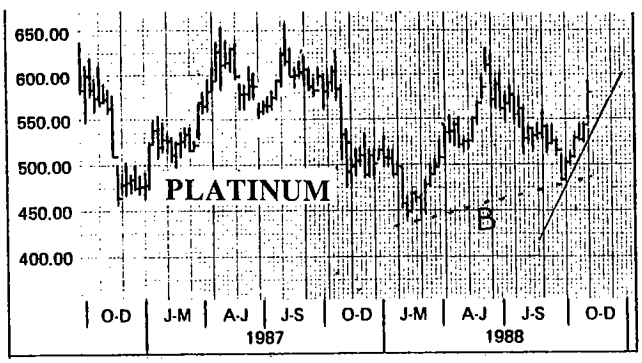
South Seas bubbles, pyramid investment trusts, Florida land, REITs, LDC loans, Texas banks and all the other market frenzies of the past, the denouement will be a crash. We and our children will pay a gigantic price for allowing abusive takeover tactics and boot-strap, junk bond takeovers." The statement is rather interesting since Mr. Lipton's firm is probably the leading law firm in the nation on takeovers. The firm received a sensational $20 million fee from Kraft in connection with the Philip Morris takeover.

PRECIOUS METALS: Between January and August, the dollar finally rallied — its biggest rally of the past three years. But as of last week, the dollar (based on the Dollar Index) had given up more than half of its January-August gains. Technically, that's a bad sign for the dollar -- but a good sign for gold.

In Letter 1002 I noted that the recent weakness in gold was not confirmed by XAU, the gold/silver average. In this Letter I am including charts showing that bellwether platinum also refused to confirm the recent weakness in gold (weekly charts courtesy of *Dunn and Hargitt*).

Referring to the chart, note that gold, on its June to October decline, fell far below its first quarter low. The breakdown is shown by the down-slanting line A on the chart. Now, the platinum chart. Here we see that platinum, on its June to October sell-off, held well above its first quarter low. That action is depicted by the up-slanting line B.





Thus two separate, important downside non-confirmations exist, gold vs. the silver/gold average, and gold vs. platinum. I believe that these two sets of non-confirmations are important, and that they are saying that the precious metals have bottomed.

A third trendline now assumes significance. This is the declining trendline connecting the January and June peaks on the gold chart (trendline marked C). A breakout above this trendline would confirm the gold bottom and indicate that gold was now in a definite bullish trend. Currently, it would take a gold advance to above 440 to reverse trendline C. However, looking at the chart it seems to me that gold should form a larger base before making a move to and above the 440 area.

Therefore, we might expect more backing and filling for gold with perhaps another dip toward the 410 area. But I believe gold has seen its low for 1988. The next major move should be -- up.

Allies Urge Bush to Act On Deficit

Europe and Japan See Market Turmoil Without Quick Plan

By STEVEN GREENHOUSE

Special to The New York Times

PARIS, Nov. 10 — European and Japanese finance officials have served notice on President-elect Bush that they expect him to take strong, quick action on the Federal budget deficit.

In interviews and speeches yesterday and today, several finance ministers, including Pierre Bérégovoy of France and Nigel Lawson of Britain, warned that the world's financial markets would suffer unless Mr. Bush signals that he will move to cut the deficit.

While they did not specify any minimum targets for deficit reduction in their statements, some said privately that they would like to see the deficit shrink to $120 billion in 1989 from its projected level of $150 billion in 1988.

These ministers are more than interested observers: their cooperation has been crucial to the United States in helping to stabilize the dollar and in calming the world's financial markets after the 1987 stock crash.

Indeed, many economists said the officials' comments had encouraged the dollar's present sharp slide.

The Bank of Japan surprised many observers by releasing a report just a day after the election saying that "despite the recent reduction of the U.S. deficit, further reduction is necessary" to stabilize the markets.

Mr. Bérégovoy said: "The U.S. is living on credit, and its indebtedness totals over one trillion dollars. No country in the world can stand this."

LATE NOTES: This article from the Nov. 12 *New York Times* deals with a situation I've been warning about for quite some time. The story is this: Japan and Europe (our creditors) have about "had it" with America's do-nothing position on both the federal and the trade deficits. Up to this point, the US (with a lot of help from its very patient friends) has staved off trouble by supporting the dollar. That kind of manipulation worked for a while, but with the election over our trading partners now want to see action. Under pressure of a falling market, Mr. Bush has announced that although he is not yet president, he is very serious about doing something about the deficits. Mr. Reagan (as we might expect) has been relatively quiet on the subject.

The formula that Mr. Bush and Congress will have to take entails (1) cutting federal spending, (2) read our creditors' lips -- raising taxes, (3) cutting US consumption. All three paths will involve pain. The longer the US twiddles its thumbs and looks the other way, the worse the pain.

The market recognized this whole situation many months ago, and that is probably the reason for the crash and it almost surely the reason for the sub-standard market performance since.

After thirteen months of hibernation, the bear is beginning to emerge from his long hiberation. On November 11 the Dow broke below the 2100 level to close at 2067.03. As of November 11 the Dow was a mere 1.9% above where it closed two days after the crash (on October 21, 1987 the Dow closed at 2027.85).

On November 11 the Dow closed literally on its 200-day moving average, which now stands at 2065. If the Dow breaks and remains decisively below its 200-day MA, such action would be very bearish.

On the same day (November 11) the advance-decline ratio closed at minus 12.14. This was its lowest level since last December, and it means that a diversified list of stocks purchased during 1988 is now "under water."

The Dow closed on December 31, 1987 at 1938.83. If the Dow was to get in step with the majority of NYSE stocks as measured by the A-D ratio, that's about where the Dow would be now -- in the 1938 area.

NEXT MAILING: Nov. 30